IN THE UNITED STATES BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION

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| IN RE: | § | |
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| EAST TEXAS HEALTHCARE, INC., et al., | § | CASE NO. 98-38547-SAF-7 (Jointly Administered) |
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| DEBTORS. | § | |
| | § | |
| DIANE G. REED, CHAPTER 7 TRUSTEE, PLAINTIFF, | § | |
| | § | |
| VS. | § | ADVERSARY NO. 02-3218 |
| | § | |
| STATE BANK & TRUST, et al., DEFENDANTS. | § | |

**MEMORANDUM OPINION AND ORDER**

Colonial Healthcare Center, Inc., and Morris Esformes move to dismiss the amended cross-complaint filed by a group of persons referred to as the East Texas Noteholders. In the alternative, Colonial and Esformes move the court to abstain. In a separate motion, Health Systems, Inc., and James Lincoln move to dismiss the amended cross-complaint. The East Texas Noteholders oppose both motions. The court conducted a hearing on the motions on January 29, 2003.

Diane G. Reed is the Chapter 7 trustee of the bankruptcy estates of several subsidiaries of Chartwell Healthcare, Inc., including three Chartwell debtors who operated nursing homes in

Missouri. Those nursing homes generated account receivables pre-bankruptcy order for relief that arguably became property of the Chartwell subsidiaries' bankruptcy estates. 11 U.S.C. § 541. Receiverships for the Missouri nursing homes had been instituted by the State of Missouri. The receivers collected the accounts receivable. One of the receivers transferred collected funds to the trustee.

On June 28, 2002, Reed filed her first amended complaint, interpleading funds the trustee received from the Missouri receiver. The trustee alleged that State Bank and Trust Company of Dallas, Texas, and the East Texas Noteholders each claimed a first priority, secured claim in the funds. The extent of their liens would exhaust the funds, leaving the trustee with no remaining interest to distribute to unsecured creditors. The trustee commenced the interpleader action for the court to determine the priority of the lien positions of State Bank and the East Texas Noteholders.

On August 13, 2002, the Noteholders filed a third party complaint against Health Systems and Lincoln. On November 27, 2002, the Noteholders filed an amended cross-complaint against Colonial, Esformes, Health Systems and Lincoln. In the amended cross-complaint, the Noteholders allege that the defendants collected receivables belonging to the Chartwell debtors in Missouri, but did not turnover the funds to the trustee. The

Noteholders claim a first priority, perfected security interest in those receivables. The Noteholders request the entry of a declaratory judgment establishing their position and the entry of a turnover judgment for the funds.

Meanwhile, on November 27, 2002, the court entered an agreed judgment resolving the competing claims of State Bank and the Noteholders to the funds interplead by the trustee. In her first amended complaint for interpleader, the trustee reserved a claim to the interplead funds "in the unlikely event" the court determined that neither State Bank nor the Noteholders had an enforceable security interest in the funds. As a result of the judgment entered November 27, 2002, the trustee's reservation of a claim is moot.

Colonial, Esformes, Health Systems and Lincoln move to dismiss the amended cross-complaint for lack of subject matter and personal jurisdiction. The court had subject matter jurisdiction over the trustee's first amended complaint for interpleader. Reed held funds that were property of the bankruptcy estates but subject to competing liens. Reed concluded that the secured creditors' competing lien priorities would exhaust the funds, so she interplead the funds for the court to determine the extent and priority of the liens. 28 U.S.C. §§ 157(b)(2)(K) and 1334(b) and (e).

In the amended cross-complaint, the Noteholders allege in effect that the defendants hold additional funds from accounts that are likewise property of the bankruptcy estates, albeit subject to their lien claims. The court has jurisdiction over property of the debtor as of the commencement of a case and of property of the estate. 28 U.S.C. § 1334(e). The court has jurisdiction to determine if property constitutes property of the estate and, if so, to require that the property be turned over to the bankruptcy estate. 28 U.S.C. §§ 157 (b)(2)(E) and 1334(b). Furthermore, the court would have jurisdiction to determine a claim of a security interest by a creditor in the property of the estate. 28 U.S.C. §§ 157(b)(2)(B) and (K) and 1334(b); 11 U.S.C. §§ 502 and 506.

Since the trustee named the Noteholders in an adversary proceeding to determine the extent and priority of their liens in funds from the Missouri nursing homes held by the trustee, the Noteholders could commence third party litigation against other persons who allegedly held property of the estate subject to their lien claims. Recovery of that property, if successful, would be applied to the secured claims of the Noteholders, thereby affecting the distributions to the creditor body of the bankruptcy estates. 28 U.S.C. § 1334(b); <u>Wood v. Wood (In re Wood)</u>, 825 F.2d 90, 93-94 (5th Cir. 1987). With subject matter jurisdiction, the court obtains personal jurisdiction over the defendants by service pursuant to Bankruptcy Rule 7004(d).

However, the amended cross-complaint cannot be reviewed in a vacuum from events in both this adversary proceeding and the underlying bankruptcy cases. The Noteholders have settled their claims against the bankruptcy estates. In their settlement with the trustee, the Noteholders dismiss with prejudice claims they assert against the bankruptcy estates except for certain reserved claims. For the reserved claims, the Noteholders and the trustee agreed that the claims would not be dismissed if necessary to preserve the Noteholders' causes of action against third persons, but, in that event, the Noteholders entered a covenant not to sue the estates. Consequently, as a result of the settlement, the Noteholders will obtain no further recovery from the bankruptcy estates on account of their claims. The trustee agreed that the Noteholders could prosecute certain defined reserved claims without interference by the bankruptcy estates and that the Noteholders would own those claims free and clear of any liens, contribution rights, or competing claims by other parties to the settlement, including the trustee. The reserved claims include the claims of a security interest in the subject funds held by the defendants. By order entered May 6, 2002, in Reed v. Heller Healthcare Finance, Inc., et al., adversary proceeding no. 99-3273, the court approved the settlement.

The defendants contend that the trustee has thereby abandoned the estates' interest in the funds. If property has been abandoned by the trustee, it would no longer be property of the estate. The Noteholders respond that the trustee has not abandoned the estates' interest in the property. Indeed, the trustee has not filed a motion to abandon the property pursuant to 11 U.S.C. § 554(a). The court has not ordered the trustee to abandon the property on request of a party in interest and after notice and a hearing. 11 U.S.C. § 554(b). The bankruptcy estates have not been closed. 11 U.S.C. § 554(c). The trustee may only abandon property of the estate pursuant to this statutory authority. In re Heil, 141 B.R. 112, 115 (Bankr. N.D. Tex. 1992). The property has therefore not been abandoned. Nevertheless, by virtue of the settlement and the interpleader, the trustee no longer claims an interest in the funds. Pursuant to the settlement, the trustee may not assert any competing claim to the funds from the Missouri nursing homes. Having been approved by the court, the settlement is binding on the trustee. Thus, even though not technically abandoned at this time, the trustee is precluded from asserting a claim to the funds. The settlement deems the claim to the funds to be owned by the Noteholders.

Notwithstanding the settlement, the Noteholders argue that this court may nevertheless direct the turn over of funds from the defendants. As discussed above, this court does have jurisdiction to order the turn over of property of the estate. 28 U.S.C. § 157(b)(2)(E). The Bankruptcy Code provides for the turn over of property of the estate "to the trustee." 11 U.S.C. § 542(a). But the trustee is not seeking that relief. Under the settlement, the trustee may not seek that relief. The court may not use the Code's "turn over" provision to order the defendants to pay the funds to the Noteholders, even if the Noteholders establish that they have a security interest in the subject funds.

Consequently, the court had jurisdiction at the commencement of the litigation. Once acquired, jurisdiction is not lost by developments concerning the litigation. But the bankruptcy estates no longer claim an interest in the subject funds. The Noteholders have either dismissed their claims against the bankruptcy estates with prejudice or entered a covenant not to sue the estates regarding the claims. Consequently, any collection by the Noteholders from the defendants based on their alleged security interest will no longer have an effect on the distributions to creditors of the bankruptcy estates.

Colonial and Esformes alternatively request that the court abstain from adjudicating this dispute. At the hearing, Health Systems and Lincoln did not oppose that alternative request for relief. Colonial and Esformes argue that abstention is either mandatory or should be granted in the exercise of the court's discretion. 28 U.S.C. § 1334(c)(1) and (2).

Discretionary abstention is appropriate. The court may abstain from hearing a particular proceeding "in the interest of justice, or in the interest of comity with State courts or respect for State law." 28 U.S.C. § 1334(c)(1); In re Gober, 100 F.3d 1195, 1206 (5th Cir. 1996). Absent a bankruptcy case, there would be no federal jurisdiction over the Noteholders' actions to pursue their alleged collateral from the defendants. Without the trustee asserting an action under § 542(a), there is no remedy established by the Bankruptcy Code. The amended cross-complaint raises matters determined by state law. The amended cross-complaint does not invoke a substantive right created by federal bankruptcy law. Litigation had been pending in state court, in which the Noteholders had sought to intervene. Presumably, with the resolution of the bankruptcy issues by settlement and the agreed judgment with State Bank, the Noteholders could renew their intervention efforts. The settlement agreement itself recognizes that the Noteholders may pursue their claims regarding the Missouri nursing homes in state court in Missouri.

Counsel for the Noteholders asserts that her law firm owns part of the Noteholders' claims and that the firm has taken an assignment of their claims. She argues that the law firm can assert the claims against the bankruptcy estate. Counsel argues, therefore, that collection by the Noteholders from the defendants could have a conceivable effect on the handling of the law firm’s claims in the bankruptcy cases. Presumably if the Noteholders recover from these defendants, part of their recovery will go to their counsel, thereby reducing counsel’s claims against this estate. By attempting to assert a claim against the estate when the Noteholders have settled their claims, counsel appears to be attempting to circumvent an order of this court approving the settlement. Counsel also appears to be attempting to undermine a portion of the settlement. This court does not anticipate allowing a distribution to counsel on account of the law firm’s alleged ownership of part of the Noteholders’ claims or from an assignment of part of the claims. And, certainly, counsel will not expect the trustee to seek to recover from the defendants in order to increase funds for distribution to creditors of the estates, including counsel, when her clients are attempting to collect directly from the defendants. Counsel’s assignment and ownership claim appears to conflict with the interests of her client. Counsel’s asserted claim does not weigh against abstaining.

Counsel for the Noteholders also asserts that the trustee is going to bring an action to collect the funds. The settlement agreement precludes an action since that would be a claim against matters reserved for the Noteholders. Furthermore, the court does not base its decision on speculation about what litigation may be commenced in the future by the trustee.

Therefore, the court determines that while it had subject matter jurisdiction as the litigation had been initially commenced, subsequent events lead the court to abstain from adjudicating the amended cross-complaint. The Noteholders may not invoke the turnover power of the trustee to collect on their alleged collateral. The state law claims for declaratory relief brought in that complaint should be pursued in state court. As a result of the settlement and the agreed judgment in the inter-pleader action, the trustee claims no interest in the subject funds and the Noteholders will not pursue any claims against the estate, regardless of the success of their collection efforts from the defendants. As state law claims remain disputed among non-debtors, comity and respect for state law weigh in favor of abstention.

As the remaining matters in the adversary proceeding have been finally resolved, with the abstention on the amended cross-complaint, the adversary proceeding shall be closed. As a result, the court need not address the motions to dismiss filed pursuant to Fed. R. Civ. P. 12(b)(6) or the motion for mandatory abstention.

Based on the foregoing,

**IT IS ORDERED** that the alternative motion of Colonial Healthcare Center, Inc., and Morris Esformes to abstain is **GRANTED.** The court shall abstain from adjudicating the amended cross-complaint against Colonial Healthcare Center, Inc., Morris Esformes, Health Systems, Inc., and James Lincoln.

**IT IS FURTHER ORDERED** that, as a result, the remaining issues raised by the pending motions need not be decided.

**IT IS FURTHER ORDERED** that this adversary proceeding is **CLOSED.**

Dated this _____ day of March, 2003.

Steven A. Felsenthal
United States Bankruptcy Judge